

# Effect of Recent Federal Legislation on the Practice of the Law of Business Associations\*

PAUL J. BICKEL†

If Rip Van Winkle had been a lawyer engaged in the active practice of what is commonly known as "corporation law," and had slept from 1933 to this day and then awakened and endeavored to resume his corporation law practice, he, like Washington Irving's Rip, would have been filled with strange wonder at the things that happened during his repose. He would now hear the names of novel statutes and governmental agencies. He would be amazed at the great volume and ramifications of new legal learning in which he would have to school himself. He would also learn that adequate training in these new subjects could not be obtained in any law school nor from treatises, but only in the school of experience.

If without advising himself with respect to recent federal legislation he should proceed on the basis of the law as it stood in 1932 he would place his clients in peril of their fortunes and their personal liberty. Their troubles would arise not only because of the statutes but also because of numerous regulations issued by governmental agencies and having the force of law.

For the purpose of this discussion, the word "recent" will be taken to mean during the last eight years. In this period, federal jurisdiction over business has been extended beyond anything previously conceived. Of course, those who have begun to practice since 1933 do not know what corporation law practice prior to that year was like, and they take these new acts for granted.

Hardly a day passes in the life of an active corporation

---

\* Address given at the annual meeting of the Association of American Law Schools before the Round Table on Business Associations on December 27, 1940.

† Member of the Cleveland Bar.

lawyer without contact with one or more of these acts. If the lawyer represents a corporate client issuing securities or represents an investment banker selling securities, he will find it necessary to consult several federal acts as well as administrative regulations issued under them.

This paper is not a treatise on the various acts here considered. Such discussion of the substance of the acts as is here included is merely a preface to a consideration of the effect of such laws on a corporation lawyer's practice. This paper aims to answer this question: "What specifically does a corporation lawyer do in his practice by reason of the acts under consideration?"

It would not be feasible to discuss all of the recent federal acts which affect a corporation lawyer's practice, but the principal ones are as follows:

1. The Securities Act of 1933, which for the purposes here under discussion is the most important.
2. The Securities and Exchange Act of 1934, which is related to the former act.
3. The Trust Indenture Act of 1939.
4. The Public Utility Holding Company Act of 1935.

All of the foregoing are administered by the Securities and Exchange Commission.

5. The Reorganization provisions of the Bankruptcy Act. This act has no connection with the other four.

Of course, the corporation lawyer must also give consideration to many of the internal revenue acts, as they have an important bearing on the reorganization of corporations. The lawyer may find that by setting up one type of reorganization his client will have a heavy income tax which can be avoided by pursuing a different course. To weigh the advantages and disadvantages of different courses the lawyer must be familiar with the applicable provisions of the Internal Revenue Code. They will, however, not be discussed in this paper. Likewise the Investment Company Act and the Investment Advisors Act

of 1940 will not here be discussed. They are too recent to furnish the basis of sufficient experience for the purpose at hand.

### THE SECURITIES ACT OF 1933

This act regulates the sale of securities where the mails or instrumentalities of interstate commerce are used. The act does not provide a censorship of securities which may be offered for sale. It is based on the principle of full disclosure on the part of issuers and sellers of securities so that prospective purchasers may be fully informed. To this end the act requires the assembling and filing of information of wide scope and detail.

In order to insure compliance with the act, it provides for civil liabilities on the part of officers and directors of the issuing company as well as on the part of underwriters and experts who certify reports. It is because of these civil liabilities that, in the case of responsible issuers and bankers, the greatest possible amount of care is taken in disclosing all information which is or conceivably may be required, and in so presenting this information that it does not become misleading by reason of the omission of other information.

The first problem presented to a lawyer is to determine whether in a given case securities must be registered under the act. Certain securities and transactions are exempt from registration. It is not feasible to enumerate all of the problems on this subject. The following are two of the principal problems which a practicing lawyer faces in regard to exemptions:

1. The act exempts from registration "transactions by an issuer not involving any public offering." This raises the question as to what is a "public offering." To how many persons may securities be offered before the transaction becomes a "public offering"? If a company offers a bond issue to a group of insurance companies, to how many companies may the offer be made without losing the exemption? In a recent matter with which I became acquainted, a large company wished to absorb a smaller company by acquiring all of its outstanding stock which

was held by forty-seven persons. Under the plan of reorganization the larger company intended to acquire the stock of the smaller company in exchange for its own stock. The question was whether the acquiring company had to register its stock under the Securities Act on the ground that it might be engaged in making a "public offering" of its stock. The Securities and Exchange Commission was consulted but it did not wish to give a written opinion. The Commission indicated, however, that so far as it was concerned registration would not be insisted upon. In order to be safe the company nevertheless registered its stock. Even if the Commission had ruled that registration was not necessary, such ruling would not protect the issuing company in the event that a court at the instance of a discontented recipient of the stock should hold that the act was violated.

Lawyers are not agreed on the meaning of the term "public offering." This uncertainty should be eliminated by an amendment to the act.

2. If a person who is in control of a corporation wishes to dispose of all or a part of his holdings in a public offering, he is subject to the same registration provisions of the act as though the company itself were selling the securities. The reason for this provision is obvious, as otherwise if the act applied only to the original issue of a security, a corporation could issue its securities to a promoter who would unload them on the public free of registration. However, in many cases it is difficult to determine whether a given person is in "control" of a corporation. The Act does not define the term. Suppose, for example, that the president of a corporation owns one-third of the stock; that he has been a director and the chief officer of the corporation for several years; that he has the confidence of the other directors and that the policies which he recommends are usually followed by the board. Is he deemed to be in control of the corporation so that in case of sale of any of his shares the company must register them? The answer to this question might depend in part upon the shareholdings of other persons. If

some other person also held one-third of the stock, or if three or four persons together held more than one-third of the stock, it might be that the president would not be deemed to be in control, because he could readily be outvoted. Furthermore, the mere fact that the president can induce the directors to file a registration statement for his benefit does not prove that he is in control. Many directors would accede to the president's request as a personal favor to him, or because his sale of securities will establish a market for those held by the directors, or because they may themselves wish to purchase or to sell securities.

The question of control should not depend upon consideration of such factors as the personalities of officers or shareholders. Where does moral leadership end and control begin? In determining control must one give consideration to the existence of large shareholdings in the hands of other persons, or the degree to which other persons have cooperated in opposing the management, etc? The ruling of the Commission in a given case will not protect a shareholder who disposes of his shares without registering them, in the event that a court should hold that he was in control of the corporation. The Act should be amended so as to give an objective definition of control. Under the Ohio Securities Act, for example, it is provided that one who holds one-fourth of a given class of securities is subject to the same registration provisions as the issuer itself.

Assuming that the conclusion is reached in a given case that the securities have to be registered, what does the practicing lawyer do? The task for the lawyers for the company and the lawyers for the bankers, working with officers and other representatives of these two interests, together with independent public accountants, is to write two long documents for filing with the Commission. One is a registration statement and the other is a prospectus which partly parallels the registration statement and which is intended for the prospective investor. This is a short statement of the lawyers' work which covers the performance of an enormous number of detailed operations.

The lawyers must determine which of the thirteen different forms of registration statements prescribed by the Commission is applicable to the case at hand. Usually there is not much difficulty on this point. The form mostly used is Form A-2 applicable to certain going concerns. This is the only form discussed in this paper. Certain other forms relate to new enterprises and reorganizations, and the requirements in those cases are more onerous than if Form A-2 applies. The lawyer must study the Instruction Book issued by the Commission which is helpful in complying with the form.

Outside of the lawyers, accountants and laymen engaged in such work, it is not commonly known that every sentence and figure in the registration statement and prospectus are the subject of much scrutiny, checking and rechecking. Usually a great many drafts of these documents have to be prepared, reviewed and revised before they are satisfactory to all persons concerned. Many questions arise as to whether certain detailed information should or should not be included. In case of doubt on this point the information is usually included. However, it is realized that if information is furnished in too great detail the possibility of error is increased.

Where securities are underwritten, particular care is exercised in disclosing in the registration statement information as to the hazards in the company's business. The skeletons in the closet are brought forth in full view. Otherwise other statements in the registration statement might be deemed to be misleading.

The process of preparing a registration statement and prospectus is made the subject of such arduous work because of the personal liability provisions in the Securities Act. While there have not been many suits under these provisions, the possibility of suit is always in the forefront of the lawyer's mind. No lawyer wishes to have his client made the victim of these provisions. In order to protect his clients the lawyer will go to great lengths in insisting upon the disclosure of a great many

details, some of which would no doubt be held by a court to be immaterial.

From the releases issued by the Commission, the writer is aware that in the case of certain promotional enterprises, particularly mining companies, the registration statements as filed are frequently misleading, and in some cases purposely fraudulent, and the Commission issues stop-orders against them. This paper does not relate to the lawyers' work in preparing statements of such enterprises.

There are portions of the registration statement which in the nature of the case must be based on information furnished by the company itself, such as the names of officers and directors, business experience of officers, their compensation and various statistical information. Other portions are furnished by independent public accountants who certify to their accuracy. Certain portions are usually written by lawyers after conference with their clients. Usually the lawyer for the company takes the initiative in writing up the statement. In cases where the company's lawyer is unfamiliar with matters of this kind, the lawyers for the bankers may take the initiative. In any case many conferences with officers or office employees of the company are necessary in order to elicit the information.

Among the items, the text of which is usually written by lawyers, are the following:

1. *Description of the General Character of the Business.*

This may seem easy but it is not. The business should be described in specific terms. If there are different departments of the business they are usually described in detail. If the company is a manufacturer, it is usual to describe the raw materials used, the manufacturing process, the names of the finished products, and the kinds of customers who purchase the products. Counsel must determine whether to include details concerning the market for the products, conditions affecting the market, patent protection, dependence on a few customers, and the like. Care must be exercised not to give a misleading picture by giv-

ing equal prominence to lines of business of different importance or subject to different hazards. If the business is subject to stringent statutory regulation as, for example, a public utility or a small loan company, there is usually included a summary of the applicable statutory provisions.

The extent to which factual and legal detail should be included under this heading is the subject of much discussion among the lawyers and laymen who prepare the statement. It is difficult to draw the line between that which is material and that which is not.

*2. General Development of the Business for the Preceding Five Years.*

Here again counsel must take the responsibility of determining what events in the history of the company for the five preceding years should be included. No two persons would write up this item in the same way. Care must be taken to include unfavorable as well as favorable developments. Matters of competition, labor strife, addition of new products, loss or increase of foreign trade, effect of recent legislation or governmental regulation, and the like, may find a place under this item. Counsel must have imagination to develop the story from laymen.

*3. General Character and Location of the Property, Plants and Other Important Units.*

This item also seems easy but here again there must be a process of selecting or eliminating details, especially in a case where the company owns many plants. It has become the custom to set forth the kind of construction of such plants, that is to say, whether frame, brick, steel, concrete, etc., also the number of floors, the floor area and the use to which it is put. It is evident that much time is consumed in writing up this item to the satisfaction of all of the persons who have to approve the registration statement. Views differ as to what are "important units" of the company.



4. *General Effect of all Material Franchises and Concessions.*

In the case of a public utility this item requires the careful preparation of an essay based on facts, constitutional provisions, statutes, ordinances and court decisions defining the company's franchise rights. Naturally in this field there are many uncertainties. Counsel for the company usually take the responsibility of summarizing what, in effect, are their legal conclusions on these matters. Counsel for the bankers examine the same questions and they have to be satisfied that the item is correct in point of fact as well as of law.

5. *Material Pending Legal Proceedings Departing from Ordinary Routine Litigation.*

This item causes much discussion because of the difficulty of drawing a line between ordinary and extraordinary litigation. Sometimes the question is one only of degree. A personal injury law suit may be deemed routine litigation in the case of some companies but not in others; likewise, litigation over the validity of patents or over orders of the National Labor Relations Board, or other governmental agencies. Here again counsel must determine what should be included or excluded. Frequently out of abundance of caution much more detail is included than a court would require.

6. *General Effect of Material Contracts Not Made in Ordinary Course of Business.*

There is no yardstick to tell which contracts fall within this item and which not. The Commission in its Instruction Book has laid down several rules which are helpful, but in the nature of the case they cannot cover the whole subject. Questions arise whether given contracts are material because they involve the purchase or sale of products in more than average amounts, or relate to the purchase of equipment in an amount that might be considered out of the ordinary, or relate to plant expansion or to services over a period of time. Owing to the vagueness of

this heading one is apt to find in registration statements digests of many contracts which probably would be held to be immaterial but which it is felt can not safely be omitted. Frequently the company is reluctant to disclose certain contracts which by being disclosed become known to its competitors. While the Commission may consent to the filing of certain contracts as confidential, it does not do so except in an unusual case. Thus, counsel have to take the responsibility of passing upon their materiality.

The foregoing, of course, is only a partial statement of the sort of problems which lawyers have to meet. The situation of no two companies is alike, and as each registration statement is the joint product of many minds, these problems are not met the same way in different cases. The more experience that a lawyer has in this field, the more readily he may come to a solution satisfactory to him. It must be remembered, however, that no such conclusions are binding upon the investor who later may claim that the registration statement omitted facts which the law or the regulations of the Commission require to be stated. The Commission can take no responsibility in regard to the inclusion or exclusion of facts, because it usually has access to no facts other than those disclosed.

A corporation lawyer must have at least a superficial acquaintance with accounting. Frequently, proper accounting depends on legal concepts. Accountants who prepare the accounting information for a registration statement must rely on counsel's opinion on certain points. Hence, the lawyers for an issuing company and for the bankers usually review the financial statements which are included in the registration statement, particularly the accountants' footnotes and explanations of depreciation, stated capital, surplus, treasury shares, obligations to retire securities, shares reserved for options and conversion privileges.

No amount of diligence on the part of counsel will enable them to make the registration statement and the prospectus

complete at the time of filing. The draftsmen of the Securities Act evidently assumed that it would be possible to prepare a registration statement at least a month in advance of the public offering of the securities. This assumption is contrary to the fact. It is impossible to state one month in advance of the sale of securities the price at which they are to be offered, and in the case of bonds and preferred stock it often is impossible to predict interest rate, conversion terms and redemption price. One of the greatest difficulties which lawyers face in preparing registration statements arises from this fact. No one can predict the market conditions one month or even several days hence. No underwriter who expects to stay in business will make a firm commitment to purchase securities twenty days in advance of the time when he can offer them to the public. Hence, when the registration statement has been written up to the satisfaction of all parties concerned, it still is incomplete in that it omits to state definitely the terms on which the securities will be underwritten, the price payable by the underwriters to the company and the price at which the securities will be sold to the public as well as the commissions payable by underwriters to dealers. While usually the company before filing a registration statement has had negotiations with bankers, it is not able to obtain from the bankers any binding commitment on the points just mentioned. Frequently a form of underwriting agreement has been drawn up but with the price left blank.

Although the registration statement is admittedly deficient in the respects just mentioned, it is filed with the Commission in that form. Before filing it, the lawyer for the issuing company should advise the directors of the personal liabilities which they may incur. Such liability is not avoided by moral innocence on their part. In the nature of the case they do not personally know all of the detailed facts set forth in the statement. If possible, the lawyer sees to it that proofs of the statement are furnished to the directors in advance of the signing. It is evident, however, that the individual directors can not possibly

check all of the statements. They must rely upon the company's office employes, accountants and attorneys.

In connection with the preparation of a registration statement, it is also necessary for counsel to prepare a prospectus. This is one of the most annoying features of the Securities Act. The prospectus includes a large amount but not all of the information in the registration statement. In order to avoid any charge of omission of that which should be included, large portions of the registration statement are reproduced bodily in the prospectus without any attempt at condensation. The mechanical difficulties growing out of this procedure were not foreseen by the draftsmen. Whenever a draft or proof of the registration statement is changed, care must be taken to make a change in the corresponding section of the prospectus. There is here a great possibility of error. Much time is consumed in comparing the two documents.

In the writer's opinion the Act would be greatly improved in administration and without damage to the investor if the registration statement were abolished and only a prospectus would need to be filed. To the extent that the registration statement contains information not included in the prospectus, the information is of practically no value to the investor. If it is considered that information in addition to that in the prospectus should be filed with the Commission, such information should be filed separately as exhibits.

About ten days after the filing of the registration statement and the prospectus, the Commission sends what is commonly called a "deficiency letter" pointing out deficiencies in the registration statement. This letter refers to the evident omission, such as those relating to underwriting and price, and points out any other respects in which the Commission considers the statement to be ambiguous, misleading or defective. Counsel will often disagree with the Commission in matters of detail, but if it is at all possible to meet the Commission's views, counsel address themselves to that task, because it is usually

easier to do so than to expend time, money and effort in going to Washington to discuss the matter with the Commission, although this also is often done. A lawyer who prepares a registration statement for the first time should not be surprised if the Commission finds many deficiencies. Lawyers who practice extensively in this field have learned the technique which enables them to exercise foresight against numerous deficiencies with which the novice would be met.

The deficiency letter from the Commission states that the deficiencies should be remedied by amendments filed by a given time. Otherwise the Commission will issue an order to prevent the registration statement from becoming effective on the twentieth day.

The lawyers therefore make haste in preparing an amendment to meet the deficiencies. If they need more time than that stated by the Commission, they send a telegram to the Commission amending the statement in respect of the proposed offering date, which starts a new twenty-day period, so that the Commission will not need to issue an order to prevent the statement from becoming effective on the twentieth day after the original filing. (The only kind of amendment that can be made by telegram is one changing the stated offering date). It is evident that counsel must do everything possible to prevent the issuing of a stop order, as that would give the securities a "black eye."

It is considered prudent to file amendments during the original twenty-day period whenever a substantial amount of either additional or correcting information is at hand. The purpose of this is to induce the Commission to make all of the amendments retroactive, which lies within the Commission's discretion, to the end that the registration statement will become effective on the twentieth day after filing. If all of the corrective amendments are delayed until the eighteenth or nineteenth day, the Commission may decline to accelerate the amendments.

In the usual case there are two or three formal amendments supplying additional information. Considerable time and effort has to be spent in the preparation of amendments, printing them, reading the proofs, having them approved by attorneys for both bankers and the company, as well as by the respective clients, and thereupon signed by many officials and filed in Washington. This process frequently requires overtime work on the part of all parties concerned, including the printer who charges time and a half for overtime work and double time on Sundays and holidays. In the usual case the printing has to be done whenever the material is available, regardless of expense. The obtaining of the signatures sometimes requires that officers and directors of the company be subject to call on short notice, and some may have to travel to distant points and in some cases even to Washington to sign there. There are also cases where they have signed signature pages in advance and trusted to counsel to annex them to the amendments. Extraordinary measures are sometimes taken to obtain the necessary signatures. When you consider that in the course of the ten days following the receipt of the deficiency letter there may have to be two or three amendments, it is evident that one amendment is hardly filed before another one has to be prepared.

These amendments are filed in the expectation that the Commission in the exercise of its discretion will date them all back as of the original filing instead of beginning a new twenty-day period with each amendment. Finally a few days before the end of the twenty-day period a definitive understanding must be arrived at between the company and the bankers so that an underwriting agreement may be signed, the price payable to the company fixed and likewise the price to the public. Thereupon the final amendment to the registration statement can be prepared. This requires the preparation, printing, signing and filing of the final amendment as well as of a copy of the underwriting agreement and a revised prospectus. This

process alone may take a few days, and frequently the final amendment is taken to Washington by plane, and one of the lawyers remains in Washington to await final action by the Commission.

With this final amendment the company files an application to the Commission to make all of the amendments retroactive.

Meanwhile the underwriters are nervous because they have signed an underwriting agreement but do not know definitely the day when the securities may be sold, that is, the day when the registration statement becomes effective. No lawyer can advise them definitely on this point. He can only tell his anxious clients who have a commitment outstanding that he expects the Commission to find that the statement is complete. Assuming that everything is in order the Commission at 4:30 p. m. on the nineteenth day will declare the statement effective and will telegraph to counsel and the company to that effect. Sometimes the telegram does not arrive until seven or eight o'clock or thereafter on that evening. These are anxious moments on the part of the bankers because they wish to know whether they can safely market the securities the next morning. If the telegram is received, the securities are usually offered on the morning of the twentieth day.

The twenty-day waiting period is responsible for many difficulties under the act, as the registration statement must be accurate on the date when it becomes *effective*. The facts set forth in the registration statement as originally filed may be altered during the period. In a case where a company is negotiating with the government on a large defense contract, or is contemplating a substantial addition to its plant, it is exceedingly difficult to write an accurate story on recent developments in its business because the situation shifts from day to day, and it is practically impossible to predict what the situation will be at the end of the twenty-day period.

Also, if the company is negotiating a labor union contract or doing other things not of a routine nature, the registration

statement must be written to reflect the truth as of the end of the twenty-day period.

In some cases an amendment is necessary because of changing conditions during this twenty-day period. Counsel endeavor to anticipate all such changes, but manifestly they cannot be omniscient. Of course, amendments can be filed each few days, but the mechanical difficulties of preparation, printing, signing and filing are expensive and awkward.

This twenty-day period operates to discourage the registration and sale of securities, because small companies and individual owners of securities may be willing to sell securities under the market conditions obtaining at the moment, but may not be willing to incur the expense of registering the securities in view of the chance that market conditions one month hence may not be as favorable as now. There have been many cases where registration statements were filed, and much expense incurred, especially for fees to lawyers and accountants, and the statement later was withdrawn because market conditions had taken an unfavorable turn. The knowledge of this fact has a deterrent influence on the sale of securities. All companies that register securities are gambling considerable money outlay on future market conditions.

Before the Securities Act was passed, it was possible to have securities marketed under the same conditions as existed when the underwriting contract was signed, this because the securities were usually offered the moment that the contract was signed. Now counsel have to exercise their ingenuity to shorten as much as possible the period between the signing of an underwriting contract and the effective date of the registration statement. The Commission has been helpful in working out a practice whereby such agreement may be filed a day or two before the expected effective date of the registration statement, and the Commission advises counsel verbally that upon such filing and a final amendment as to price, the registration statement would appear to be complete. Nevertheless, the uncertainty as to date



when the securities may lawfully be marketed is not removed until the actual receipt of official word from the Commission that the registration statement is in effect.

Counsel representing the bankers must be astute in protecting his clients as much as possible against the change of market conditions between the date of signing the underwriting agreement and the time when the securities can be sold. Because of this time element, a modern underwriting agreement is not much more than an option, and the risk that the securities may never be marketed is usually thrown on the Company as the agreement usually gives the bankers the right to cancel in case of change of market conditions.

In the following special cases, among others, there are peculiar problems presented which require considerable skill or ingenuity on the part of counsel:

1. Suppose a company whose common stock is listed on stock exchange desires to sell additional common stock which, in the first instance, must be offered to its own common stockholders, and the sale of which is to be underwritten, how will you fix a record date as of which the stock is to be offered to its stockholders, as such date must, of course, be subsequent to the effective date of the registration statement, but should be mentioned in such statement? Here the company must indulge in some prediction, which is exceedingly awkward.

2. In the case cited, how will you state in the registration statement the price at which the stock is to be offered to the stockholders? Also, the price at which the unsold portion is to be sold to the underwriters? Also, the price at which the underwriters propose to sell to the public? Manifestly, a fixed price must be stated in the case of the offering to the stockholders, but a fixed price at which the underwriters will sell the securities to the public cannot be stated. Their price must necessarily be about the same as the then current price on the stock exchange. Lawyers have spent many hours on these problems. There is no satisfactory solution. The difficulty

arises from the necessity of stating in a registration statement, long in advance the happening of the event of offering, the offering price or the formula by which the offering price will be determined. The Commission scrutinizes the statements as to price to make sure that they are clear and do not leave too much to future determination.

You will note from the foregoing that compliance with the Securities Act is mechanically difficult and awkward. The act is too rigid and inflexible to suit actual conditions. The requirement of obtaining signatures of the chief executive officers and a majority of the directors not only to the registration statement as originally filed but also to all of the amendments is inconvenient, and, I believe, not necessary to protect investors. The draftsmen did not foresee the necessity of such amendments.

Recently the Act has been amended to authorize the Commission in a given case to shorten the twenty-day period. How helpful this will be remains to be seen. The Commission's staff will still require considerable time to examine the statement as originally filed, including the detailed financial statements. Furthermore, in spite of this amendment no banker will commit himself to a final agreement at the time of filing the original registration statement because he cannot tell in advance how long his commitment will be outstanding.

It follows from what has been said that where securities have to be registered under the Act, lawyers' services are required in much greater volume than in other cases. Frequently, as many as five lawyers in the firm representing the company or the bankers work on the registration statement, the underwriting agreement and incidental matters. If, for example, the company is in Ohio, and the bankers in New York, numerous trips of New York bankers and lawyers may be made to Ohio, of Ohio lawyers and company officers and directors to New York, and of company and bankers' lawyers to Washington. If it is necessary to comply not only with the Securities Act, but also with the Trust Indenture Act and the Public

Holding Company Act, legal services which are conditions precedent to marketing the securities require the effort of many lawyers, not to mention the company's and the bankers' office representatives.

A recent report issued by the Commission shows that since the passage of the Securities Act, fees of lawyers and accountants are about twice as much as they were in the case of comparable securities issued before the passage of the Act. The total cost of financing has gone down because of the cheapness of money, but the out-of-pocket outlay for professional services has been increased.

#### SUGGESTED AMENDMENTS TO THE SECURITIES ACT

In the interests of economy of time, money and effort the following amendments to the Securities Act are proposed:

1. The registration statement as such should be abolished. The documents to be prepared and filed with the Commission should be the prospectus, together with exhibits containing such additional information as is deemed necessary. Thus, the present duplication between the registration statement and the prospectus, and many of the present mechanical and expensive steps involved in their preparation would be eliminated, and the investor would be as fully informed as under present conditions.

2. The \$100,000 exemption should be increased to a larger amount. The expense of registering an issue of less than \$500,000 is practically prohibitive. It is suggested that issues of under \$250,000 be exempt under the same conditions that issues of \$100,000 are now exempt, and that issues of between \$250,000 and \$500,000 be exempt in the case of going concerns.

3. Some formula should be devised to exempt, on the mere filing of simple information, issues of companies which for a stated period have been in business, have operated profitably, and have furnished annual operating statements and balance sheets to their security holders. The companies which meet such

tests are not apt to defraud investors. The Securities Act was not aimed at companies of this sort. The draftsmen of the Act undoubtedly had in mind new enterprises, where the public is asked to finance a speculative, particularly companies to exploit natural resources or to deal in other outstanding securities, as in the case of the "investment trusts" or "management trusts" or speculative holding companies of the kind which thrived in the boom period.

Every lawyer and every member of the Commission's staff could quite readily compile a list of profitable going concerns which are likely never to sell securities on fraudulent or misleading information. In practice, the securities of such companies are sold on the basis of their reputation and not because of detailed information contained in a registration statement. The pertinent facts as to most of such companies are already public property. It certainly seems practicable to devise a formula which would exempt companies of this sort from registration requirements, and nevertheless continue to require registration on the part of new enterprises, as well as going companies which do not meet the test of age, earnings and publicity. Such exemption would lift a large burden from American business of the better kind.

4. There should be exemptions from registration for a limited period of time in favor of companies that have previously registered securities under the Act, where no stop order has been issued and additional financial statements have been made available to the public, or the company has listed securities on a stock exchange. Possibly this exemption should be applicable only to companies that have been in business for a fixed minimum period of time so that no new speculative enterprise could take advantage of it.

5. The Commission should be authorized to issue a certificate in advance of the effective date of a registration statement to the effect that on condition that no complaint be filed or defect be subsequently discovered, the registration appears

to be complete and *will be* effective on the twentieth or other stated day, or stating that the registration statement, without further action by the Commission, will be deemed complete on the filing of certain specified information. With such advance knowledge the company and the bankers could make final preparations for the public offering on the stated day, subject, of course, to the routine completion of the registration statement if not already completed, and subject to the power of the Commission in a proper case to issue a stop order at any time. Under present conditions even though all parties have done everything which they think should be done and counsel are morally certain that the registration is complete, there is still uncertainty as to when it will be effective, and the parties do not know when it will be effective until the Commission states affirmatively that it *is* effective. Advance additional commitment by the Commission as to the effective date would reduce this uncertainty to negligible proportions and be most helpful.

6. Where the parties have filed with the Commission an underwriting agreement in final form except that the names of the underwriters and the price payable by the underwriters are not stated and have filed a prospectus also complete except as to such names, and the price to the underwriters and to the public, the law should permit the transmission of the missing information to the Commission by telegraph. As matters now stand, after the prices have been fixed, it is necessary to prepare a final price amendment, to have it printed, signed by the principal officers and a majority of the directors and taken to Washington, whereupon the parties have to wait until the Commission makes this amendment retro-active so as not to begin a twenty-day waiting period anew. If the final price amendment could thus be sent by telegraph, many mechanical steps would be saved and the public offering could be made without the two or three day delay which results from the preparation and filing of a formal amendment and awaiting the action of the Commission thereon.

7. In view of the fact that amendments to registration statements are the rule and not the exception, it should not be necessary to have each amendment signed by all of the principal officers and a majority of the directors of the issuing company. In the typical case there are probably three amendments. The mechanical steps incident to obtaining these signatures are awkward and inconvenient, and while a director may grant a power of attorney to sign, counsel and officers are frequently hesitant in asking for such authority. It would seem feasible to have amendments signed by the President and the Secretary or two officers if there be furnished to the Commission evidence that the board of directors have authorized filing of amendments by them.

8. In lieu of the vague word "control" as used in the Act there should be some objective test to determine whether individuals wanting to sell their own securities must have them registered by the issuing company.

9. In place of the indefinite term "public offering" there should be substituted some term of certain meaning. A company should be permitted to offer securities to a fixed minimum number of employes without registration. Likewise an offering should be permitted to be made to persons of a given class as, for example, creditors or shareholders of another company, where such class is not greater than a fixed minimum, without registration. Likewise an offering of securities for cash to a fixed minimum number of persons should be permissible without registration. The point is that there should be a mathematical test for registration.

#### THE SECURITIES EXCHANGE ACT OF 1934

This Act covers a variety of subjects. It regulates stock exchanges, provides for the registration with the Commission of securities listed on exchanges, prohibits various manipulative devices in the purchase and sale of securities and regulates the use of proxies in the case of corporations with shares listed on a stock exchange.

For present purposes the only provisions of the Act which will receive attention here are those which a practicing corporation lawyer encounters most frequently.

1. The lawyer assists in the preparation of a registration statement filed with the Commission as a preliminary to listing securities on a stock exchange. The filing of information with the Commission is in addition to compliance with the applicable rules of the particular exchange. In the event that the corporation has previously filed with the Commission a registration statement under the Securities Act of 1933, the preparation of a registration statement under the Act of 1934 is a matter of relative ease. The preparation of a registration statement under the Act of 1934 is simpler than under the Act of 1933 not only for the reason that less information has to be included but also because the lawyer does not have to obtain the approval thereto of so many people as, for example, bankers and their attorneys. Moreover, the liability provisions of the Act of 1934 for furnishing false or misleading information are not as severe as the corresponding provisions under the Act of 1933.

2. It has long been and still is the practice of investment bankers while engaged in marketing a given security to stabilize the price during the offering period. This is attempted by repurchasing securities which have been sold by the underwriters or dealers and then put on the market by the purchaser. The Act prohibits stabilizing operations contrary to such rules as the Commission may issue. The Commission recently has issued rules on this subject. The practicing lawyer representing an investment banker must make himself familiar with these rules. They are highly technical and their substance will not be discussed here.

3. The Act provides that no person shall use the mails or instrumentalities of interstate commerce to solicit proxies in respect of any security registered on a securities exchange in contravention of such rules as the Commission may prescribe

on this subject. Under the provision the Commission has issued rules governing the solicitation of proxies among holders of securities listed on a stock exchange. These rules are, therefore, applicable to thousands of corporations. This is an innovation which would not have been thought of years ago. The purpose of the rules is to require the solicitor of a proxy to give full information to the stockholders whose proxies are being solicited. Practically every corporation solicits proxies for the annual meeting, as well as for any action which under the law must be taken by stockholders, such as amendments to articles of incorporation, reorganization, etc. Without solicitation, action by shareholders as a group can usually not be brought about, unless control is vested in a holding company or a small group of persons. These rules are quite detailed and technical and a digest of them will not here be made. Suffice it to say that corporation lawyers must learn to prepare a document heretofore unknown, called a "proxy statement," which must contain certain information which the Commission considers that a stockholder should have before signing a proxy, including a statement whether the person giving the proxy has the power to revoke it, a summary of any applicable provisions of law relating to appraisal or similar rights of dissenters with respect to any matter to be acted upon pursuant to the proxy, and a statement as to who pays the cost of soliciting the proxy. A difficult provision is the one requiring a statement that if solicitations of proxies are to be made otherwise than by use of the mails, the character of such solicitation must be stated and the cost or anticipated cost thereof. It may be difficult in many cases to ascertain whether or not the corporation will make personal solicitation of stockholders. If the mails fail to bring in proxies in an amount sufficient to transact the business at hand, perhaps the officers of the corporation will make personal calls on such stockholders as are available. If such is in contemplation, the proxy statement must reveal it.

If the proxy is for an annual meeting, the proxy statement



must set forth the names for whom the person holding the proxy intends to vote. It must also set forth the salaries of such of the nominees as are among the three highest paid officers, and the statement must describe any connection between nominees and recent underwriters of securities of the corporation. If the proxy is to be voted on a proposal to authorize or issue securities otherwise than in exchange for outstanding securities, the proxy statement must contain full information with respect to the new securities, the transaction in which the new securities are to be sold, the amount of consideration to be received therefor, and the purpose for which the net proceeds are to be used. This requirement raises many difficulties because it requires the corporation to predict long in advance of a given action what the nature of it may be. It should be added, however, that the rule permits the omission of information which is not known and not reasonably available and it provides that information as to matters to occur in the future need be given only in terms of present intention.

A preliminary copy of the proxy statement must be filed with the Commission ten days in advance of the date of mailing to the security holders. The purpose of this ten-day period is to enable the Commission to scrutinize the proxy statement and to insist on changes if the Commission considers it inadequate. In practice it may be necessary in many cases to have personal conferences with the Commission to iron out differences of views as to the content of the proxy statement. Because of this requirement, these additional ten days must be added to the period otherwise required to consummate any corporate action requiring a stockholders' meeting.

4. Under Section 16 of this Act a person who is directly or indirectly the beneficial owner of more than ten per cent of any class of securities registered on a stock exchange or who is a director or officer of the issuer of such security must file reports with the Commission of any changes in his ownership of securities of such corporation, and he must account to the corporation

for any profits made by him in case he purchases and sells or sells and purchases securities of such issuer within a period of six months, with certain exceptions of no importance here.

The writer has grave doubts of the constitutionality of this provision. Its connection with interstate commerce is exceedingly remote. However, a practicing lawyer cannot advise his client to ignore it. This provision has given rise to many questions as to who is the beneficial owner of a security. Suppose, for example, that Smith owns a majority of the stock of the Smith Company and the Smith Company in turn owns ten per cent of the stock of a corporation whose securities are listed on the New York Stock Exchange; suppose the Smith Company buys and sells securities of such corporation in which it has a ten per cent interest, is Mr. Smith deemed to be the beneficial owner of the securities so traded in so that he is liable for the profits made by purchases and sales within a period of six months? In the writer's opinion the answer to this question is "No." But you will realize that in certain circumstances it may be claimed that a person's control over a corporation may be so evident, or his ownership of securities in such corporation may come so close to one hundred per cent, that he might be considered to be the beneficial owner of such securities as the corporation owns, in which case such person might have to account for the profits made by such corporation in buying and selling listed securities. This is merely one of the types of questions arising under this Section.

#### TRUST INDENTURE ACT OF 1939

The Act is based on the assumption that heretofore trustees in trust indentures in many cases were disqualified to act with undivided loyalty to the bondholders because of dual interests, or that they failed to protect the interests of bondholders because of inadequate rights and powers, and that the indentures did not require them to keep the security holders advised of defaults, that the release provisions of the indentures were too

loose and the exculpatory clauses were too favorable to the trustees. To remedy these evils, which are enumerated in the preamble of the Act, trust indentures subject to the Act must contain certain specific provisions relating to the qualifications and duties of the trustee.

In cases where the securities to be issued under the indenture are registered with the Commission under the Securities Act of 1933, the Commission will not permit the registration statement to become effective if it finds that the indenture does not conform to the Act or that the trustee is not eligible. A copy of the indenture must be filed with the registration statement. Accordingly, the Commission reviews the trust indenture as filed to see whether it conforms to the Act. This Act therefore adds one more condition precedent to the sale of bonds in interstate commerce.

Obviously the function of the lawyer who drafts a trust indenture which is subject to the Act is to put in the indenture all of the provisions required by the Act, and to make sure that there are no conflicting provisions, and to satisfy the Commission that he has complied with the Act.

Indentures subject to the Act are necessarily much longer and more detailed in so far as the trustee's duties are concerned than heretofore.

In case the indenture relates to securities which are not registered under the Securities Act, an application for qualification of the indenture must be filed with the Commission and the Commission reviews the indenture to ascertain its conformity with the Act.

Trust indentures in any case are long and involved documents and it is quite likely that in many cases it will be difficult to iron out any difficulties with the Commission without a personal conference. Moreover, it is altogether likely that at the first filing of a registration statement the indenture is not in final form but is subject to review by the attorneys for the bankers and the company as well as the proposed trustee.

Accordingly, as changes are agreed upon by these parties from time to time revised forms of the indenture must be filed with the Commission and its attention must be called to changes that have been made. It is difficult enough to have the various parties in interest agree upon the form and substance of an involved indenture. Obviously it is also difficult to obtain the approval thereto of a governmental agency located at a distant point, which does not participate in the numerous conferences between the bankers' and the company's lawyers at which the indenture is discussed and revised, a process which in itself is apt to consume much of the twenty-day period.

### PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Under this Act the Securities and Exchange Commission is granted power to regulate many activities of interstate public utility holding companies and their subsidiaries. The Act, of course, looms large in the practice of lawyers whose specialty is public utilities. They must prepare for their clients applications of many sorts to obtain the Commission's approval to acquisition of interests in other companies, the issuing of securities and many other matters. To the general corporation lawyer having to do with the issuing of securities, the principal points of contact will be those giving the Commission jurisdiction over the issuing of securities. In the usual case if a holding company must be registered with the Commission, its subsidiaries can not issue securities without obtaining the approval of the Commission. Certain securities are required by the Act to be made exempt from such approval but even in that case the Commission must be furnished with information showing that the exemption applies. The lawyer's function is the preparation of the appropriate application to the Commission and the furnishing of testimony, if need be, in support of it. These proceedings before the Commission can go along simultaneously with the pendency of a registration statement filed under the Securities Act of 1933, although the proceedings under the

Holding Company Act are before a different division of the Commission. Usually a copy of the registration statement filed with the registration division must be filed as an exhibit before the holding company division, and as amendments are made to the registration statement copies thereof must be filed with the holding company division. It would seem that this procedure could be simplified by the Commission itself so that one filing with the Commission would be sufficient. The procedure under the Trust Indenture Act is integrated with the procedure under the Securities Act of 1933 but that is not the case under the Holding Company Act.

If a public utility which is a subsidiary of a registered holding company sells an issue of bonds in interstate commerce, it must simultaneously comply with three acts, the Securities Act of 1933, the Trust Indenture Act of 1939 and the Public Utility Holding Company Act of 1935, all of which are administered by the Securities and Exchange Commission. It requires all of a lawyer's ingenuity and diligence to bring about compliance with these three laws in the shortest possible time and without delaying the effective date of a registration statement.

During the twenty-day period provided for under the Securities Act of 1933, many different operations must be simultaneously carried forward by the lawyers for the company and the bankers. Certain of the lawyers will be in almost constant conference in the city in which either the company or the bankers are located, in the preparation of amendments to the registration statement; others will be revising the trust indenture, one or more may be in Washington conferring with the Commission about the amendments, the trust indenture, and the requirements of the Holding Company Act, and relaying to their associates by telephone the views of the Commission; other lawyers may be preparing applications and amendments thereto under the Holding Company Act. and all this work has to be coordinated by those who have authority to make decisions. Naturally, no important changes are made without the concur-

rence of representatives of the company and the bankers. Every effort is made so that at the earliest moment after the registration statement takes effect, the securities may be offered simultaneously in all of the states where the dealers who are parties to the offering are located. The addition of the Trust Indenture and the Holding Company Acts to the Securities Act has made an interstate offering of bonds of a public utility company a very complicated and intricate matter. If a lawyer experienced in this field were to write a treatise to point out all of the applicable legal requirements and to instruct the novice how to go about it, he would be writing a large book. There is no such book in existence, and if there were, it would soon be out of date. If a lawyer memorized the applicable statutes, his education would be deficient. He would be helpless if he did not have access to the regulations issued from time to time by the Commission, and the official forms. Even the printed literature is not sufficient to advise the lawyer the best way to proceed in all cases. In case of many large issues of securities, personal conference with the Commission in Washington is advisable. This is particularly true where the Trust Indenture Act or the Holding Company Act are concerned.

It is evident that the four securities acts here considered have had a great impact on investment banking practice, but also on a corporation lawyer's practice. From the standpoint of constitutional law, counsel have become accustomed to a greatly enlarged concept of interstate commerce. Stock exchanges were formerly considered as being engaged solely in intra-state commerce and therefore subject to state regulation only. Years ago who would have thought that the federal government would regulate the solicitation of proxies, the private purchase and sale of securities of officers of corporations whose securities were listed on a stock exchange; and, (as evidenced by regulations just issued by the Commission) the manner in which brokers must safeguard the securities of their customers?

## REORGANIZATION PROVISIONS OF THE BANKRUPTCY ACT

In 1933 Congress amended the Bankruptcy Act by adding Section 77 relating to the reorganization of railroad companies in the Bankruptcy Court; in 1934 it added Section 77B which provides for the reorganization of corporations generally; in 1938 it enacted the Chandler Act which included Chapter X to take the place of Section 77B.

These acts are not especially revolutionary, as their purpose is to provide for the reorganization of corporations by judicial proceedings, and the prescribed procedure bears considerable resemblance to the well known form of reorganization through equity proceedings in the federal courts. The lawyer familiar with this procedure will not feel that Chapter X places him in a strange field, but he must keep in mind the following innovations in the new procedure:

1. In the case of reorganization of corporations other than railroads, the plan of reorganization, instead of being prepared by the interested parties, must be prepared and submitted to the court by the disinterested trustee. This is a striking innovation in the act. Usually the trustee consults with representatives of security holders, because he will not wish to propose a plan which will not meet with favor on the part of influential parties. Theoretically, at least, the trustee should be in a position to take a more detached view than is possible in the case of committees representing specific groups of security holders. The functioning of the trustee in this respect depends upon his own honesty, fairness, wisdom and experience and the like qualities of his counsel.

2. The Bankruptcy Court has express power to pass on the fairness of the plan, and this enlargement of jurisdiction should make for fairer treatment of security holders and tend to lessen the nuisance value of unjustified claims or claims whose security is wiped out.

3. The powers granted to the Securities and Exchange Commission under the Act are likewise a striking innovation. If the

scheduled indebtedness of the debtor exceeds \$3,000,000, a plan of reorganization must be submitted to the Securities and Exchange Commission for examination and report. If less than that amount is involved, the court may, but is not required to, submit a plan to the Commission. The Commission has intervened in many cases involving less than \$3,000,000 and has taken an active part in the preparation of plans of reorganization. The Commission's power is advisory only. The Commission here is called upon to perform a function which the judge with his limited time and lack of an expert staff at his command can not adequately perform. In practice representatives of the Commission participate in conferences with the trustee and other interested parties at which plans of reorganization are devised or considered, and the Commission expresses its views on various proposals. It thus has considerable influence in shaping the plan. The Commission has consistently taken the view that no new securities should be issued to security holders whose equity is wiped out, a result which is required by the decision in the case of *Case v. Los Angeles Lumber Co.*<sup>1</sup> Under the former equity procedure security holders without real equity were frequently accorded new securities, this for the reason that they had it within their power to prolong the proceedings, to contest senior claims, raise issues which would require hearings and trials, etc. Under the decision just mentioned and with the influence of the Commission junior interests without real equity can be more readily wiped out. The fact that the Commission's report is advisory only does not diminish its influence because the Commission has an adequate staff to make an examination of the debtor's business, assets and prospects which the court does not have, and there is no reason why the Commission should have any bias in favor of any particular group. The author's observation thus far has been that the Commission's activities have been of value to the court and the parties.

As an illustration of a beneficial reorganization under the

---

<sup>1</sup> 308 U.S. 106 (1939).



Bankruptcy Act where there was otherwise no adequate remedy, the writer would refer to a certain case where a bondholders' committee had caused foreclosure proceedings to be brought before Section 77B was passed. The Committee represented 86% of the bonds but it was unable to purchase the property at foreclosure sale because it had no means to pay 14% of the purchase price in cash to the non-depositing bondholders. The outcome might have been disastrous for all of the bondholders if a petition had not been filed under Section 77B which had become effective meanwhile. Under this section the committee was able to present a plan of reorganization under which all of the bondholders would receive new securities, no cash being required. The Act made possible the preservation of the business as a going concern in the interest of all of the bondholders. In the absence of Section 77B there might have been a sacrificial sale on a liquidation basis.

The nature of the lawyer's duties in connection with reorganization proceedings depends upon the party he represents. The most desirable client in this connection to represent is the trustee, because the trustee is practically in charge of the proceedings. He takes or can take the initiative in preparing a plan and it is his counsel who has to keep the proceedings going, prepare orders with reference to filing claims, rejecting contracts, classifying creditors, paying certain prior liens, compromising claims and obtaining authority from time to time on behalf of the trustees to meet problems arising in the conduct of the business. Knowledge of equity receiverships on the part of the trustee's lawyer is quite helpful. The lawyer for the trustee can make himself the principal factor in these proceedings and his wisdom, judgment and fairness will go a long way towards a satisfactory reorganization. Lawyers for other parties may be active in pressing allowance of their claims, objecting to claims of other parties, proposing amendments to the plan of reorganization, opposing such plan and doing whatever may be necessary or desirable to protect the interests of their particular

clients. It is evident that knowledge of general matters of pleading and trial procedure in general is helpful in these judicial procedures.

These reorganization proceedings are largely displacing reorganization under creditors' or foreclosure bills. The lawyer having to do with these proceedings will meet many new questions, and, dependent upon his imagination and courage, there is much room for pioneering. The practice in different federal districts is not uniform. Undoubtedly many lawyers will specialize in this particular field and they will not all be drawn from the ranks of bankruptcy lawyers.

### CONCLUSION

The extension of federal jurisdiction over securities as provided for in recent legislation is likely to be permanent, subject, however, to amendments of these laws from time to time. There has been much agitation for amendments to the Securities Act of 1933 to make it more flexible and workable. Some way ought to be found to remove the many mechanical difficulties in complying with this Act, as well as to exempt from registration the securities of going companies that are not apt to impose on investors.

The Securities and Exchange Commission has from time to time revised its regulations to make them more workable. In doing so the Commission has frequently consulted with investment bankers and their attorneys. In the future there will probably be more and more collaboration between the Commission and the industry, and many improvements in the various acts and the regulations will undoubtedly be made. Naturally a corporation lawyer must keep himself informed of these changes.